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No. 194

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

AMERICAN BEMBERG CORPORATION, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above-entitled case March 14, 1958.

CITATIONS TO OPINIONS BELOW

The opinion of the Court of Appeals is reported at 253 Fed. (2nd) 691, and is printed in the Appendix hereto, p. 1a.

The opinion of the District Court is reported at 150 F. Supp. 355, and appears in the record at pages 178a-195a. It is printed in the Appendix hereto, p. 6a.

JURISDICTION

The judgment of the Court of Appeals was entered March 14, 1958. Petition for rehearing was denied by the Court of Appeals April 22, 1958. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

QUESTIONS PRESENTED

I

May a liability which is contingent and contested by the taxpayer be deducted in computing taxable income?

II

Does the word "profits" when used to determine the availability of funds for corporate use mean undistributed profits?

Or does the word "profits" have the same meaning as taxable income?

III

Should the Court of Appeals be reversed where an issue was raised in the District Court and findings made with respect thereto and the Court of Appeals held the question was not raised?

IV

In the construction of a contract, should the intention of the parties be ascertained and given effect?

STATUTES INVOLVED

The statutory provisions involved are Sections 23 and 43 of the Internal Revenue Code of 1939, which read as follows:

"I.R.C. of 1939, Sec. 23.

"DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions;

* * * * * *

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

I.R.C. of 1939, Sec. 43.

"PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

"The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

STATEMENT

Some time prior to 1925 a new rayon product commonly known as Bemberg was invented in Germany and successfully manufactured in that country. The German inventors and manufacturers were anxious

to place Bemberg on the American market. Accordingly, the appellant was incorporated in Delaware in 1925. The capitalization of the organization was 140,000 shares of no par common and $3,500,000 of 6% preferred stock.

Between 1925 and 1939 the majority of the non par common voting stock was owned by two German corporations, Vereinigte Glanzstoff Fabriken (hereafter referred to as the V.G.F.) and J. P. Bemberg. In 1929 Algemeene Kunstzijde Unie (hereafter referred to as A.K.U.), a Netherlands corporation, acquired control of V.G.F. and, subsequently acquired some of the shares owned in American Bemberg by the V.G.F. so that A.K.U., together with V.G.F. and J. P. Bemberg, owned the majority of the voting stock of American Bemberg from 1939 to 1950.

The preferred stock certificate provides that the preferred stock dividends shall be paid from the "surplus or net profits of the corporation."[1]

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[1] The provision of the preferred stock certificate dealing with the payment of dividends states: (Ex. E) (R. 3)

"The holders of the preferred stock shall be entitled to receive when and as declared by the Board of Directors, from the surplus or net profits of the corporation, dividends at the rate of seven per cent per annum and no more, payable semi-annually. Such dividends on the preferred stock shall be payable before any dividends shall be paid or set apart on the common stock and shall be cumulative from July 1, 1925 (except that on preferred stock issued after December 31, 1925, the dividends shall be cumulative from the 1st day of the half-yearly period in which such stock is issued). Whenever dividends at the rate of seven per cent per annum upon the preferred stock for all past half-yearly periods shall have been declared and the same shall have been paid by the corporation, or funds for the payment thereof shall have been set aside, the Board of Directors may declare dividends on the common stock, payable either in cash, stock or otherwise, at such time as the Board of Directors may determine, out of any remaining surplus or net profits."

In order to make the preferred stock salable to a banking syndicate and, in turn, attractive to the American investing public, the German corporations guaranteed the payment of the semi-annual cumulative dividends on the preferred stock from July 1, 1925 to July 1, 1929. That guaranty was made in a written contract which provides:

(1) If the American Bemberg should be unable or fail to pay the semi-annual dividends, the German corporations would punctually pay the amounts unpaid.

(2) If the German corporations made advances under the guaranty agreement, they would be repaid by the American corporation, together with 5% interest. However, no repayments were to be made until

(a) The current semi-annual dividend should be declared on the preferred stock and a sum sufficient for the payment thereof set apart for that purpose and,

(b) No reimbursement was to be made to the German corporation except out of the profits of the American corporation.[2]

---

[2] The contract provisions stating the terms of the guaranty read as follows: (R. 45a)

"Third: Upon making any payment pursuant to said guaranty, to or for the benefit of any holder of any such certificate for such preferred stock of the American Corporation, Glanzstoff and/or Bemberg shall forthwith without further act or deed, thereupon be subrogated to and shall acquire and shall be possessed of all the rights which the holders of such certificates would otherwise have against the American Corporation with respect to any payment of dividend, non-payment of which by the American Corporation will thus have been made good by Glanzstoff and/or Bemberg; and the said holder, his successor and assigns shall thereafter be limited in his or their rights against the American Corporation in all respects as though such payments had been made to such holder by the American Corporation by way of

The District Court analyzed the agreement as follows: (Appendix hereto, p. 16a)

> "Reimbursement could not be made until and unless the regular dividend for the current semi-annual period was declared upon the outstanding preferred stock and sufficient sums for the payment thereof set aside; nor could reimbursement to the guarantor be made except out of the profits of American Bemberg. The declaration of the semi-annual current dividend, the setting aside of a sufficient sum to pay it, and the existence of profits, were the conditions which had to be met before the liability to pay principal and interest

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dividend; and Glanzstoff and/or Bemberg shall be entitled to be reimbursed directly by the American Corporation for any and all such payments made by Glanzstoff and/or Bemberg pursuant to said guaranty, together with interest at the rate of 5% per annum, in such manner, to such extent and at the earliest date as may lawfully be permitted, and to that end, it is hereby agreed that Glanzstoff and/or Bemberg shall be entitled to all accumulations of dividends upon such preferred stock which shall not have been paid by the American Corporation, and the amount of which Glanzstoff and/or Bemberg have paid to the record holders of certificates for such preferred stock pursuant to said guaranty; and it is further agreed that whenever the American Corporation declares dividends on account of any or all such accumulations of dividends, the same shall be paid to Glanzstoff and/or Bemberg, provided however, that no dividends shall be declared and paid on account of any such accumulation of dividends, or reimbursement made to Glanzstoff and/or Bemberg until and unless the regular dividend for the then current semi-annual period shall have been declared upon the outstanding preferred stock of the American Corporation, and a sum sufficient for the payment thereof set apart for that purpose; nor shall any reimbursement be made to Glanzstoff and/or Bemberg except out of the profits of the American Company; nor, in the event of any liquidation, dissolution or winding up of the affairs of the American Corporation, whether voluntary or involuntary, shall any reimbursement be made to Glanzstoff and/or Bemberg until the holders of the preferred stock shall have received $110 per share plus all unpaid accrued dividends."

became absolute. These conditions rendered the obligation to repay principal and interest contingent until such time as they were satisfied. The taxable year in which the conditions were satisfied is the year in which the contingent interest liability became absolute and consequently the year in which the interest accrual had to be made for tax purposes."

The Court of Appeals properly described what happened under the agreement as follows: (Appendix hereto, p. 3a)

> "What actually happened was this. The German corporations advanced Bemberg $796,250. to meet its dividend obligations to preferred stockholders between 1925 and 1929. From 1925 to 1935 Bemberg suffered annual losses except during 1928 and 1933. It earned a profit in each of the years from 1936 to 1940. Excluding dividends accumulated but not paid on preferred stock from 1930 to 1939, profits as of 1939 were sufficient to enable Bemberg to repay with interest with advances made by the German corporations. But if the amount of unpaid dividends accumulated on the stock since 1930 should be deducted from income before a profit is recognized, the taxpayer would still show a cumulative deficit at the end of 1939. The addition of further profits earned in 1940 would be necessary to repay all past dividends and the sums owed to the German corporations. Believing this latter analysis to be correct, the taxpayer accrued in 1940 the entire obligation for interest since 1925 and claimed that amount as a 1940 income tax deduction. The taxing authorities, however, took the view, to which the district court was persuaded, that 'profits', such as would fix the interest obligation, existed in 1939, so that only the current annual increment of interest could thereafter be deducted for 1940."

The District Court found: (Appendix p. 19a)

> "The meaning of the word 'profits' was not questioned until 1939. In that year the guarantor made demand for repayment which was resisted by the taxpayer on the ground of nonavailability of profits for that purpose. In addition, in 1939, taxpayer sought the assistance of counsel as to the meaning of the word 'profits' as used in the agreement."

The Commissioner of Internal Revenue allowed an interest deduction for 1940 in the amount of $32,459.98. The balance of the interest paid, $419,230.23, was not allowed as a deduction for any year. (Appendix, p. 13a)

The District Court denied recovery on the ground that the general usage and meaning of the term "profits" requires that profits be determined without regard to the distribution of dividends. The Court of Appeals affirmed. In other words, the District Court and the Court of Appeals held that the word "profits" is synonymous with "taxable income." The Court of Appeals further held that the Court below had not been presented with the contention that the obligation to repay had not become fixed in 1939 because it was being resisted.

REASONS FOR GRANTING THE WRIT

I

The decision below is in conflict with the decision of this Court in *Dixie Pine Products Co.* v. *Commissioner*, 320 U.S. 516, which states: (p. 519)

> "It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of in-

debtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer."

A few of the many other cases announcing the same basic rule as the *Dixie Pine Products* case are:

Security Flour Mills Co. v. *Commissioner,* 321 U.S. 281.

Pierce Estates, Inc. v. *Commissioner,* (CA 3, 1952), 195 F. (2d) 475.

Joseph v. *Commissioner,* (CA 5, 1943), 136 F. (2d) 410.

Commissioner v. *Brooklyn Radio Service Corp.,* (CA 2, 1935), 79 F. (2d) 833.

Ismert-Hincke Milling Co. v. *U. S.,* (CA 10, 1957), 246 F. (2d) 754.

The District Court in the case at bar disregarded the interpretation placed on the contract by the parties on the ground there was a dispute. The District Court states: (Appendix p. 19a)

"* * * The meaning of the word 'profits', was not questioned until 1939. In that year, the guarantor made demand for repayment which was resisted by taxpayer on the ground of non-availability of profits for that purpose. In addition, in 1939, taxpayer sought the advice of counsel as to the meaning of the word 'profits' as used in the agreement. Disagreement between the parties and the seeking of advice of counsel as to the meaning of the word 'profits' are not acts consonant with a particular meaning affixed to the word, as advocated by taxpayer."

Despite the findings of fact quoted above and the further statement of the District Court (Appendix

p. 15a) that "In 1939 there was a demand for repayment which was resisted by the taxpayer", the Court of Appeals says that American Bemberg "did not undertake to establish in the District Court * * * that its obligation to repay the German lenders did not become fixed as early as 1939 because it was then resisting the claim of the lenders."

The quoted findings of the District Court show that the Court of Appeals statement is directly in conflict with those findings. It is established that a Court of Appeals must be reversed where it "made an inference of fact directly in conflict with the * * * findings for which * * * the record affords no support whatever." *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200.

The contingent nature of the obligation prior to 1940 is the fundamental issue which has been in the case since the beginning. If there had been no contingency there would have been no case.

The District Court specifically found: (Appendix p. 17a)

> "These conditions rendered the obligation to repay principal and interest contingent until such time as they were satisfied."

The taxpayer's testimony on this point was all that could have been offered. It was sufficient for the District Court to make the comments quoted above.

Had this taxpayer attempted to accrue and deduct in 1939 the interest here involved, the Government would have properly disallowed the deduction because of the dispute. The rule should work both ways if chaos is to be avoided in the interpretation of the taxing laws.

II

The decision below is in conflict with the decision of this Court in *Hormel* v. *Helvering*, 312 U.S. 552, which states: (p. 558)

> "The plain implication of that decision [General Utilities and Operating Co.] was that the cause would have been remanded to the Board of Tax Appeals had the Court considered the newly raised point to be of sufficient merit. These decisions and others like them, while recognizing the desirability and existence of a general practice under which appellate courts confine themselves to the issues raised below, nevertheless do not lose sight of the fact that such appellate practice should not be applied where the obvious result would be a plain miscarriage of justice."

While petitioner does not concede that the issue was not raised in the District Court, if this Court should agree with the Court of Appeals that it was not raised, the rule of the *Hormel* case should apply.

This is so because (1) the Court of Appeals was in error when it held that the issue of contingency was not presented to or considered by the District Court and, (2) if not reversed, the decision below will do an injustice by denying to the taxpayer an interest deduction of $419,230.23 which the statute says is deductible.

III

The decision below is in conflict with established law that "profits" available for corporate use or distribution means undistributed profits or earned surplus.

The situation usually arises in connection with the availability of "earnings or profits" to pay dividends.[3]

This means the decision below is in conflict with *Foley Securities Corporation* v. *Commissioner*, (CA 8, 1939) 106 F. (2d) 731, which states that dividends (which by statute are payable out of earnings or profits) are paid out of earned surplus. Of course, earned surplus means earnings or profits less distributions therefrom.

Typical of the many cases which so hold are:

W. S. Farish & Co. v. *Commissioner*, (CA 5, 1939), 104 F. (2d) 833, which states:

> "It is well settled that impairment of capital or paid in surplus of a corporation which resulted from operating lossses must be restored before any earnings can be available for distribution to the stockholders."

To the same effect see *Van Norman Co.* v. *Welch*, (CA 1, 1944) 141 F. (2d) 99.

This Court has consistently recognized the rule, although there appears to have been no necessity to spell it out. Thus, in *Commissioner* v. *Bedford*, 325 U.S. 283, the Court points out (p. 290) that "earnings and profits exceeding the distributed cash" had been earned. Consequently, a distribution therefrom was taxable.

There are literally hundreds of decisions dealing with the meaning of "earnings and profits." Mertens' Law of Federal Taxation, § 9.26, states:

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[3] Section 115, Internal Revenue Code of 1939, states that dividends are payable "out of earnings or profits to the extent thereof."

> "In the case of corporations organized after February 28, 1913, the accumulated earnings or profits or the accumulated deficit is the net difference for the period from date of organization to the distribution year between the deficits of loss years and the earnings of profit years adjusted, of course, for distributions chargeable against earnings and profits."

A footnote to the foregoing states:

> "This principle is recognized as basic in all the cases cited in the ensuing footnotes."

The rule was codified in § 312 of the Internal Revenue Code of 1954, which states:

> "Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—
>
> (1) the amount of money,
>
> (2) the principal amount of the obligation of such corporation, and
>
> (3) the adjusted basis of the other property so distributed.

The District Court stated that: (Appendix p. 20a)

> "* * * unless it is assumed 'net profits and surplus' are synonymous, which assumption the Court is unable to accept."

The Court of Appeals affirmed this position.

It is petitioner's contention that the courts below are clearly wrong because "profits" available for corporate use is synonymous with surplus, as the author-

ities cited above demonstrate. Any rule to the contrary is out of step and will breed litigation.

The difficulty in the courts below was that they confused "taxable income" with "profits" available for corporate use. Of course, dividends and income taxes paid are not deductible in computing taxable income. However they are deductible in computing "profits" available for corporate use.

In *Commissioner* v. *Godley's Estate* (CA 3, 1954), 213 F. (2d) 529, decided by a panel of the Third Circuit different from that which decided the case at bar, the Court states: (p. 532)

> "* * * there is general agreement that 'earnings and profits' are not the same as taxable net income."

It is sheer nonsense to hold, as was held below, that "profits" which have been distributed to shareholders as dividends are to be considered as "profits" available for corporate use.

The decisions below are utterly unrealistic, as well as contrary to law. They hold that the parties intended by the contract here involved to provide for repayment of the advances and interest at a time when, admittedly, there were no funds with which to make payment. The sole purpose of the guaranty agreement was to insure the success of the American corporation. With that purpose in mind, it is unrealistic to believe they would have contracted to enforce repayment or establish an accruable liability at a time which would have jeopardized the taxpayer's solvency.

This is further emphasized by the fact that the preferred stock certificate, drafted simultaneously with

the guaranty agreement, provides for payment of preferred dividends out of "surplus or net profits," and for the payment of common dividends "out of any remaining surplus or net profits." Obviously, the parties used the commonly-accepted understanding of this business language. They should be taxed on the same understanding of the language.

IV

The decision below is in conflict with the established rule of this Court that in the construction of contracts the intention of the parties should be ascertained and given effect.

In *Brooklyn Life Insurance Co.* v. *Dutcher*, 95 U.S. 269, this Court stated:

> "There is no surer way to find out what parties meant, than to see what they have done."

As long ago as *Bradley* v. *Washington, Alexandria and Georgetown Steamboat Packet Co.*, 13 Pet. 89, this Court announced the rule as follows: (p. 97)

> "* * * It is a principle recognized and acted upon by all Courts of Justice, as a cardinal rule in the construction of all contracts, that the intention of the parties is to be inquired into; and, if not forbidden by law, is to be effectuated. * * *"

In the case at bar the record plainly shows that during the entire life of the contract the parties construed the term "profits" as we here contend. Both the District Court and the Court of Appeals recognize this to be so, although the District Court does state that, in 1939 just prior to World War II, the German corporation "made demand for repayment which was

resisted by the taxpayer on the ground of non-availability of profits for that purpose."

The Commissioner, a third party, should not be permitted to construe a contract in a manner different from that as construed by the parties. This is particularly true when the Commissioner's construction results in the denial of a deduction for interest which the statute says is deductible.

Respectfully submitted,

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July 21, 1958

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,335

AMERICAN BEMBERG CORPORATION *Appellant*

v.

UNITED STATES OF AMERICA

Appeal from the United States District Court for the District of Delaware

Argued February 3, 1958

Before: GOODRICH, McLAUGHLIN and HASTIE, *Circuit Judges.*

Opinion of the Court

(Filed March 14, 1958)

HASTIE, *Circuit Judge.*

American Bemberg Corporation is a Delaware corporation and an accrual basis taxpayer. This corporation, which we shall call Bemberg or the taxpayer, appeals from a judgment of a district court denying its claim for a refund of income and excess profits taxes for 1940. The principal issue is whether the taxpayer's originally contingent obligation to pay interest on certain advances became so definite and unqualified in 1940 that the accumulated amount thereof could be claimed in that year's tax return as an accrued and deductible expense. Viewing the obligation as having become fixed before 1940, the district court decided against the taxpayer. D. Del. 1957, 150 F. Supp. 355. We now review that ruling.

The obligation here involved arose out of certain expenditures made between 1925 and 1929 for Bemberg's benefit by its principal voting stockholders, two German corporations, Vereinigte Glanzstoff Fabriken and J. P. Bemberg, Actiengesellschaft. In order to make a cumula-

tive preferred stock issue of the taxpayer attractive to the American public, the two German corporations guaranteed the punctual payment of semi-annual dividends on that stock from July 1, 1925 to July 1, 1929. The agreement, which was in writing, provided that the sums advanced under its terms would be repaid by the taxpayer with interest at the rate of five per cent per annum. However, the obligation to repay was qualified as follows:

> ". . . and to that end, it is hereby agreed that Glanzstoff and/or Bemberg shall be entitled to all accumulations of dividends upon such preferred stock which shall not have been paid by the American Corporation, and the amount of which Glanzstoff and/or Bemberg have paid to the record holders of certificates for such preferred stock pursuant to said guaranty, and it is further agreed that whenever the American Corporation declares dividends on account of any or all such accumulations of dividends, the same shall be paid to Glanzstoff and/or Bemberg, provided however, that no dividends shall be declared and paid on account of any such accumulation of dividends, or reimbursement made to Glanzstoff and/or Bemberg until and unless the regular dividend for the then current semi-annual period shall have been declared upon the outstanding preferred stock of the American Corporation, and a sum sufficient for the payment thereof set apart for that purpose; nor shall any reimbursement be made to Glanzstoff and/or Bemberg except out of the profits of the American Company; . . ."

Paraphrasing and construing this agreement the court below said:

> "Reimbursement could not be made until and unless the regular dividend for the current semi-annual period was declared upon the outstanding preferred stock and sufficient sums for the payment thereof set aside; nor could reimbursement to the guarantor be made except out of the profits of American Bemberg. The declaration of the semi-annual current dividend, the setting aside of a sufficient sum to pay it, and the existence of profits, were the conditions which had to

be met before the liability to pay principal and interest became absolute. These conditions rendered the obligation to repay principal and interest contingent until such time as they were satisfied. The taxable year in which the conditions were satisfied is the year in which the contingent interest liability became absolute and consequently the year in which the interest accrual had to be made for tax purposes."

The taxpayer does not challenge this analysis.

What actually happened was this. The German corporations advanced Bemberg $796,250. to meet its dividend obligations to preferred stockholders between 1925 and 1929. From 1925 to 1935 Bemberg suffered annual losses except during 1928 and 1933. It earned a profit in each of the years from 1936 to 1940. Excluding dividends accumulated but not paid on preferred stock from 1930 to 1939, profits as of 1939 were sufficient to enable Bemberg to repay with interest with advances made by the German corporations. But if the amount of unpaid dividends accumulated on the stock since 1930 should be deducted from income before a profit is recognized, the taxpayer would still show a cumulative deficit at the end of 1939. The addition of further profits earned in 1940 would be necessary to repay all past dividends and the sums owed to the German corporations. Believing this latter analysis to be correct, the taxpayer accrued in 1940 the entire obligation for interest since 1925 and claimed that amount as a 1940 income tax deduction. The taxing authorities, however, took the view, to which the district court was persuaded, that "profits", such as would fix the interest obligation, existed in 1939, so that only the current annual increment of interest could thereafter be deducted for 1940.

Thus, the matter in dispute is the meaning of language in the agreement between the taxpayer and the German corporation; more particularly, whether the term "profits" was so used by the parties as to comprehend the excess of income over expenses and losses without reference to divi-

dends. The dispute is even narrower than this, for the taxpayer concedes that the existence and amount of profits normally are determined without regard to dividends and undertakes to read into the present arrangement an agreement upon an extraordinary accounting treatment of unpaid dividend obligations as losses which must be offset before there is a profit. The taxpayer relies on two facts, the cumulative character of the dividend obligation and the fact that the parties agreed that a current dividend must be paid before the obligation to the German corporations should become unqualified.

We think the terms of the German guaranty are rather plainly inconsistent with the extraordinary interpretation the taxpayer urges. We already have quoted a provision of the basic agreement which seems to accord the German lenders priority, after payment of a current semi-annual dividend, over Bemberg's preferred stockholders, impressing the lenders' claims upon profits, normally available to satisfy any dividend claims of preferred stockholders accumulated over the years. These provisions make sense only if the profits to which the parties refer exist as such before the cumulative obligations for past dividends are satisfied.

It is also urged that the provision which keeps the obligation to the German lenders contingent until a semi-annual dividend shall be paid necessarily implies that prior cumulative dividend obligations must also be satisfied to make the obligation to the guarantors unqualified. But this contention would have force only if we should accept the premise that a Delaware corporation cannot declare and pay to its preferred stockholders the amount of its current dividend obligation until cumulative obligations to them for past years shall have been paid. But no authority is cited in support of such a proposition and it appears to be contrary to the corporation law of Delaware. See the elaborate discussion of the Delaware statutes in *Weinberg* v. *Baltimore Brick Co.*, 1955, 114 A.2d 812.

These observations seem sufficient, when read with the careful analysis which appears in the opinion of the district court, to dispose of the principal argument on this appeal.

The taxpayer also attempts to make another point which it did not undertake to establish in the district court. It urges here for the first time that its obligation to repay the German lenders did not become fixed as early as 1939 because it was then resisting the claims of the lenders. Whether such a contention concerning 1939 could help the taxpayer in his affirmative undertaking to prove that the obligation accrued in 1940, we need not consider. Any legal significance the taxpayer's 1939 conduct might have would depend upon the nature, the grounds and the extent and duration of its alleged resistance to the lenders' claims. A contention which requires such factual elaboration cannot be introduced into this case as a new matter on appeal.

The judgment will be affirmed.

A true Copy.
Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

Opinion

Howard L. Williams (of Morris, James, Hitchens and Williams) Wilmington, Delaware, Robert Ash and Carl F. Bauersfeld (of Ash, Bauersfeld & Burton) Washington, D. C., and George Heftler, of counsel, Union City, New Jersey, for plaintiff.

Leonard G. Hagner, U. S. Attorney, Wilmington, Delaware, Charles K. Rice, Assistant Attorney General, Andrew D. Sharpe and Kurt W. Melchior, Department of Justice, Washington, D. C., for defendant.

WRIGHT, District Judge.

This is an action for refund of income and excess profits taxes.

The plaintiff, American Bemberg Corporation, was incorporated under the laws of Delaware in 1925.[1] Originally, the capitalization consisted of $3,500,000, 7% preferred stock and 140,000 shares of common stock having no par value.[2] Two years later Class B no par value common stock was issued.[3] Between 1925 and 1929 the majority of the voting stock was owned by two German corporations. Vereinigte Glanzstoff Fabriken (hereinafter referred to as V.G.F.) and J. P. Bemberg.[4] In 1929, Algemeene Kunstzijde Unie (hereinafter referred to as A.K.U.) a Netherlands corporation, acquired control of V.G.F. and subsequently acquired some of the shares owned in American Bemberg by V.G.F. so that A.K.U. together with V.G.F. and J. P. Bemberg owned a majority of the voting stock of the plaintiff from 1929 up to 1940.[5]

In order to make the preferred stock issue of the plaintiff salable to a banking syndicate and in turn attractive to the American investing public,[6] V.G.F. and J. P. Bemberg guaranteed the semi-annual dividends from July 1, 1925 to July 1, 1929.[7] The guaranty agreement between the plaintiff and the guarantors is as follows:[8]

> "Agreement made this 16th day of July, 1925, between VEREINIGTE GLANZTSOFF FABRIKEN, ACTIENGESELLSCHAFT, and J. P. BEMBERG, ACTIENGESELLSCHAFT, German corporations, parties of the first part, (here-

[1] Par. 1 of the Complaint, admitted in par. 1 of the Answer.

[2] T R p. 21.

[3] Ibid.

[4] T R p. 31.

[5] T R pp. 31-32.

[6] T R p. 22.

[7] T R p. 21.

[8] Exhibit "A" attached to the Complaint.

inafter respectively called 'Glanzstoff' and 'Bemberg'), and AMERICAN BEMBERG CORPORATION, a Delaware corporation, party of the second part, (hereinafter called the 'American Corporation'), and on behalf of itself and of all future holders of the preferred stock hereinafter mentioned,

"WITNESSETH:

"In consideration of the mutual agreements hereinafter contained, and of other good and valuable considerations, the receipt whereof is hereby acknowledged, the parties hereto agree with each other as follows:

FIRST: Glanzstoff and Bemberg hereby jointly and severally guarantee to each holder of record for the time being of certificates representing 35,000 shares of the preferred stock of the par value of $100 each about to be issued by the American Corporation, the due and punctual payment of semi-annual dividends upon the stock represented by such certificates at the rate of 7% per annum for the period from July 1, 1925 to July 1, 1929, inclusive, and Glanzstoff and Bemberg hereby jointly and severally agree that if the American Corporation should itself be unable to or fail to pay as contemplated by the terms of such preferred stock certificates and of the Certificate of Incorporation therein referred to the semi-annual dividends at the rate of 7% per annum upon said preferred stock for such period then, and in any such event, they will punctually pay any amount unpaid by the American Corporation in respect of such dividends without notice or demand; and any record holder of certificates representing such preferred stock then entitled to the benefit of the guaranty herein contained, either individually or jointly with other record holders of such certificates so entitled or by an agent duly appointed for such purpose, may immediately upon failure to receive any dividends on the day on which they are payable as provided in certificates representing such preferred stock, and without the necessity of proving any other fact or on demand upon or refusal of the American Corporation, proceed to enforce such payment by Glanzstoff and Bemberg.

"SECOND: There shall be endorsed upon each certificate for said shares of preferred stock of the American Corporation to be presently issued, and upon each certificate from time to time duly issued for and upon the transfer of certificates for such stock on or before July 1, 1929, the following legend:

"'Vereinigte Glanzstoff Fabriken, Aktien-Gesellschaft and J. P. Bemberg, Aktien-Gesellschaft, both German Corporations, have by agreement dated July 16, 1925, with American Bemberg Corporation, guaranteed the payment of semi-annual dividends upon the stock represented by this certificate for the period from July 1, 1925 to July 1, 1929, inclusive, and by acceptance of this certificate the holder hereof becomes entitled to the benefits and subject to the provisions of said agreement.'

"THIRD: Upon making any payment pursuant to said guaranty, to or for the benefit of any holder of any such certificate for such preferred stock of the American Corporation, Glanzstoff and/or Bemberg shall forthwith without further act or deed, thereupon be subrogated to and shall acquire and shall be possessed of all the rights which the holders of such certificates would otherwise have against the American Corporation with respect to any payment of dividend, nonpayment of which by the American Corporation will thus have been made good by Glanzstoff and or Bemberg; and the said holder, his successor and assigns shall thereafter be limited in his or their rights against the American Corporation in all respects as though such payments had been made to such holder by the American Corporation by way of dividend; and Glanzstoff and or Bemberg shall be entitled to be reimbursed directly by the American Corporation for any and all such payments made by Glanzstoff and or Bemberg pursuant to said guaranty, together with interest at the rate of 5% per annum, in such manner, to such extent and at the earliest date as may lawfully be permitted, and to that end, it is hereby agreed that Glanzstoff and or Bemberg shall be entitled to all accumulations of dividends upon such preferred stock which shall not have been paid by the American Corporation, and the amount of which Glanzstoff and/or

Bemberg have paid to the record holders of certificates for such preferred stock pursuant to said guaranty, and it is further agreed that whenever the American Corporation declares dividends on account of any or all such accumulations of dividends, the same shall be paid to Glanzstoff and or Bemberg, provided however, that no dividends shall be declared and paid on account of any such accumulation of dividends, or reimbursement made to Glanzstoff and or Bemberg until and unless the regular dividend for the then current semi-annual period shall have been declared upon the outstanding preferred stock of the American Corporation, and a sum sufficient for the payment thereof set apart for that purpose; nor shall any reimbursement be made to Glanzstoff and or Bemberg except out of the profits of the American Company; nor, in the event of any liquidation, dissolution or winding up of the affairs of the American Corporation, whether voluntary or involuntary, shall any reimbursement be made to Glanzstoff and or Bemberg until the holders of the preferred stock shall have received $110. per share plus all unpaid accrued dividends.

Fourth: This agreement shall enure to the benefit of and shall bind the successive holders of record from time to time of certificates for the 35,000 shares of preferred stock of the American Corporation now being issued. The persons in whose names such stock is recorded on the books of the American Corporation shall for all the purposes hereof, be regarded as the owner thereof and such record holders are alone entitled to the benefit of the provision of this agreement. Payment made to or upon the order of any such record holder shall be valid and effectual to discharge and satisfy all liability of Glanzstoff and Bemberg with respect to the stock of which such person is the holder of record to the extent of the sum so paid.

"Fifth: Each successive holder of shares of preferred stock of the American Corporation bearing endorsed thereon the legend hereinbefore in Paragraph Second recited, shall by its acceptance thereof, become for all purposes a party to this agreement as though he had originally signed and executed the same.

"In Witness Whereof, the parties hereto have executed this agreement as of the day and year first above written at New York City, New York.

"Vereinigte Glanzstoff Fabriken
Actiengesellschaft
By F. Blnethgen

"J. P. Bemberg Actiengesellschaft
By W. Langenbruch

"American Bemberg Corporation
By Dr. A. Mothwurf"

V.G.F. paid[9] the entire amounts of the semi-annual dividends for the guaranty period with the exception of one-half of the amount due for the semi-annual dividend period ending June 30, 1928, and the entire amount due for the semi-annual dividend period ending December 31, 1928. These advances were necessary under the guaranty agreement because the plaintiff had no profits from which to pay the preferred stock dividends.[10] The dates of payment and the amounts thereof were as follows:[11]

December 31, 1925	$122,500.00
June 30, 1926	122,500.00
December 31, 1926	122,500.00
June 30, 1927	122,500.00
December 31, 1927	122,500.00
June 30, 1928	61,250.00
June 30, 1929	122,500.00
Total	$796,250.00

V.G.F. assigned its rights under the guaranty agreement to A.K.U. in 1939.[12]

[9] T R p. 47; J. P. Bemberg, the other guarantor made no advances under the guaranty agreement.

[10] T R pp. 22-23.

[11] Complaint, par. 7; Stipulation of Facts, par. 6

[12] T R pp. 36, 48.

V.G.F. made the advances to American Bemberg, or to its transfer agent, who disbursed the payments to the preferred stockholders.[13] While the court reads the agreement as silent with respect to the method of payment of the advances, the plaintiff and the government stipulated V.G.F. made advances to the plaintiff under the terms of the agreement.[14] American Bemberg did not consider this method of payment a deviation[15] from the agreement.

Whenever the advances were made to it under the guaranty agreement, the plaintiff declared a dividend to the preferred stockholders of record,[16] although to do so

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[13] T-R pp. 22, 40, 45-46.

[14] Stipulation of Facts, par. 6; Complaint, par. 7.

[15] T-R. 32-33.

[16] The initial confusion of the record on this point, (T-R p. 39—no dividends were declared except those paid out of the earnings of American Bemberg in 1928; T-R p. 40—it is possible some of the dividends were declared payable by the guarantor) was removed by the introduction of Plaintiff's Exhibit 2 which reads as follows:

> "Minutes of a Special Meeting of the Board of Directors of American Bemberg Corporation, held at the office of the Ver. Glanzstoff-Fabr, E'fld, Germany, on the 23rd day of December, 1925, at 4 o'clock in the afternoon.
>
> "There were present: Messrs. Dr. Bluethgen, Dr. Springorum, Carl Benrath Wilh. Langenbruch, Alfr. Schoenlicht, Ludolf Rosenheim, Kurt Meyer, Dr. Hartogs, constituting a majority of the Board.
>
> "Dr. Bluethgen was elected Chairman, and Mr. Langenbruch was Secretary of the meeting.
>
> "The Chairman then stated that the semi-annual dividend upon the Preferred Stock of the Company would be due and payable on January 1, 1926, and that in accordance with the customary American practice, it would be necessary to declare the dividend to stockholders of record ten days prior thereto. He further stated that the company did not have earnings available to pay such dividend, and that accordingly pursuant to to the agreement of guaranty dated July 16th 1925, between the Company and Vereinigte Glanzstoff Fabriken Aktien Gesellschaft, and J. P. Bemberg Aktien Gesellschaft, the latter Companies would advance to this Corporation on or before December 25, 1925, the sum of $122,500, being the semiannual dividend of 3½% upon the $3,500,000 preferred stock of this Corporation.
>
> "On motion duly made and seconded, it was unanimously
>
> "RESOLVED that a dividend of 3½% be declared to the holders of record on December 19, 1925 of the $3,500,000 Preferred Stock of this

was illegal under the Delaware law.[17] In making the dividend declarations, the directors of the plaintiff corporation did not intend to deviate from the agreement[18] and thought they were acting pursuant to its terms.[19]

According to its statement of profit and loss, per its books,[20] the plaintiff showed losses for the first three years of operation (1925-1927), a profit for 1928, losses for 1929-1932, a profit for 1933, a loss for 1934-1935, and a profit for 1936 through 1940. If the aggregate of profit and loss, per its books, is calculated together with adjustments, the plaintiff would have had sufficient profits in 1939 from which to repay V.G.F. the amount which it had advanced under the guaranty agreement, together with interest. However, when there is deducted from this aggregate figure the amounts paid as dividends on the preferred stock for the years 1930-1939, plaintiff shows a cumulative deficit in 1939 if calculated from the inception of the business. The plaintiff, having interpreted the agreement as imposing no liability on it until this deficit was erased, did not accrue[21] interest on the advances made by V.G.F.

Corporation, out of the moneys advanced to this Corporation pursuant to the agreement of guaranty dated July 16, 1925, between this Corporation and Vereinigte Glanzstoff Fabriken Aktien Gesellschaft and J. P. Bemberg Aktien Gesellschaft:

"There being no further business to come before the meeting, it was adjourned.

"(S) W. Langenbruch
Acting Secretary"

Counsel for the government conceded similar resolutions to Plaintiff's Exhibit 2 were adopted for each payment in question, T-R pp. 43-44, 173.

[17] Del. Corp. Law Anno. § 170.

[18] T-R p. 33.

[19] Plaintiff's Exhibit 2, see n. 16.

[20] Plaintiff's Exhibit "AA".

[21] The taxpayer keeps its books and files its income tax return on the accrual basis of accounting and reports its income on a calendar year basis (admitted in pleadings, Complaint par. 5, Answer par. 1).

pursuant to the guaranty agreement on its books. Nor did it take any deduction for interest on its Federal income tax returns for any year prior to 1940.[22] In that year, the plaintiff accrued $537,468.75 as interest on the advances.[23] However, the amount of the debt was adjusted and reduced as of April 30, 1943 so that if the accrual of interest in 1940 was proper, the amount deductible from the plaintiff's Federal income tax was reduced to $451,690.21, which sum was actually paid to A.K.U. and claimed as a deduction.[24]

The Commissioner of Internal Revenue disallowed the deduction for interest by denying a claim for refund of taxes paid pursuant to a statutory notice of deficiency except to the extent of $32,459.98. This sum was allowed as an interest accrual, and represented the annual increment of interest for 1940, if interest accrual was permitted, but required to be made annually.[25]

This action results from the Commissioner's denial of the major portion of the interest deduction.

The government contends the amount of the repayment to A.K.U., the assignee of the guarantors, over and above the amount originally advanced to the taxpayer during the years 1925 through 1929 was payment of a dividend rather than interest.

The government and the taxpayer stipulated the German corporations made advances to the plaintiff to pay semi-annual dividends in the amount of $796,250 under the terms of the agreement.[26] It is not disputed these funds were used by the taxpayer to pay the dividends in ques-

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[22] T-R pp. 23, 48-49.

[23] T-R p. 49.

[24] Stipulation of Facts, par. 7; Exhibit "C" to Exhibit "B" attached to Complaint.

[25] Admitted in pleadings.

[26] Stipulation of Facts, par. 6; Complaint, par. 7.

tion. Nor is it controverted the German corporations and the taxpayer entered into the agreement of July 16, 1925, guaranteeing dividends to the preferred stockholders of American Bemberg, in order to attract American capital into the new company. On these facts, it is concluded the amount of the repayment over and above the sum originally advanced constitutes interest, as per the agreement, on loans made by the German guarantor to the taxpayer.

This conclusion is not altered because reimbursement was conditioned so as to be contingent. "A loan is no less a loan because its repayment is made contingent." *United Gas Improvement Company* v. *Commissioner of Internal Revenue*, (3 Cir. filed Dec. 31, 1956), citing with approval *Island Petroleum Company* v. *Commissioner of Internal Revenue*, 57 F. 2d 992, 994 (4 Cir. 1932).

Having determined part of the payment to A.K.U. was interest, it must be decided whether such interest should have been accrued by the taxpayer year by year from the respective times the original advances were made.

Generally a corporate taxpayer on an accrual basis must take its interest deductions ratably throughout the period during which it is liable for interest. However, where the obligation to pay interest is subject to the happening of a later event, the interest may not be accrued because there can be no accrual of a liability while it is contingent.[27]

Whether the liability for interest by American Bemberg to the assignee of the foreign guarantor was absolute or contingent depends upon the meaning to be given the third paragraph of the guaranty agreement of July 16, 1925. If this paragraph is completely unconditional as regards the payment of interest, although conditional with respect to payment of principal, the taxpayer should have made annual interest accruals.

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[27] Dixie—Pine Products Co. v. Commissioner, 320 U.S. 516, 519 (1944).

The government stresses the conditions set forth in the third paragraph of the guaranty agreement are conditions to "reimbursement" and not conditions with respect to payment of interest. It is often difficult to determine the meaning of a word as it is used in an agreement. The meaning of "reimbursement" depends upon its context, the nature of the business in hand, the purpose and interest of the parties to the agreement, and any other relevant circumstances.[28]

The agreement provides the German corporations shall "... be entitled to be reimbursed directly by the American corporation for any and all such payments made by Glanzstoff and/or Bemberg pursuant to said guaranty, together with interest at the rate of 5% per annum. . . ." No dispute arose between the parties as to the interpretation of the agreement until 1939, although the agreement was made in 1925. During the interval between 1925 and 1939, interest was neither demanded by the guarantor, or paid by the taxpayer. The failure to demand or pay interest would indicate both the guarantor and the American taxpayer interpreted the agreement as conditioning not only repayment of principal, but also the payment of interest.

In 1939 there was a demand for repayment which was resisted by the taxpayer.[29] However, there is no indication such demand was solely for interest or solely for principal. Even when there was a difference of opinion between the parties, both apparently agreed interest and principal were to be treated similarly. Where the ". . . conduct of the parties subsequent to a manifestation of intention indicates that all the parties placed a particular interpretation upon it, that meaning is adopted if a reasonable person could attach it to the manifestation." Restatement, Contracts § 235(e). See, *Natco Corporation* v.

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[28] 3 Corbin on Contracts, § 549.

[29] T-R pp. 24-30, 35.

United States of America, (3 cir. filed December 19, 1956). On the basis of the language employed in the agreement and the interpretation of the argreement by the parties as exhibited by their conduct subsequent to their entry into the agreement, it is concluded payment of interest was subject to the same conditions as repayment of principal.

Did the conditions attached to the repayment of principal and interest to the guarantor justify the failure to annually accrue interest on the advances? The controlling legal principles are well settled:

> "In the case of a taxpayer on the accrual basis of accounting an item of expense is to be regarded as incurred, and hence deductible as accrued, only in the year when the taxpayer's liability to pay it becomes definite and absolute, whether or not it is presently paid or payable. On the other hand if the liability to pay the item of expense is wholly contingent upon the happening of a subsequent event the item cannot be regarded as incurred or deductible as accrued until the year in which by the occurrence of the event the contingent liability becomes an absolute one. Because interest is compensation for the use or forebearance of money it ordinarily accrues as an item of expense from day to day even though its payment may be deferred until a later date. But this is not true if the payment is not merely deferred but the obligation to pay at all is wholly contingent upon the happening of a later event, as, for example, the subsequent earning of profits. In the latter case, the interest may not be regarded as an accrued expense until the year in which, by the earning of the profits, the contingency is satisfied and the obligation to pay becomes fixed and absolute." Pierce Estates v. Commissioner of Internal Revenue, 195 F. 2d 475, 477 (3 Cir. 1952).

See *Nateo Corporation v. United States of America*, (3 Cir. filed Dec. 19, 1956).

Reimbursement could not be made until and unless the regular dividend for the current semi-annual period was declared upon the outstanding preferred stock and suffi-

cient sums for the payment thereof set aside; nor could reimbursement to the guarantor be made except out of the profits of American Bemberg. The declaration of the semi-annual current dividend, the setting aside of a sufficient sum to pay it, and the existence of profits, were the conditions which had to be met before the liability to pay principal and interest became absolute. These conditions rendered the obligation to repay principal and interest contingent until such time as they were satisfied.[30] The taxable year in which the conidtions were satisfied is the year in which the contingent interest liability became absolute and consequently the year in which the interest accrual had to be made for tax purposes.

The 1939 semi-annual dividend together with all remaining arrearages[31] was declared and paid in 1939. This condition having been satisfied in that year, there remains only the question of whether the condition relating to reimbursement of the guarantor out of profits was satisfied in 1939 as the government contends or not until 1940 as the taxpayer urges. The year in which this condition was satisfied depends upon the meaning of "profits" as used in the agreement.

The general meaning and usage of the term, "profits", requires that profits be determined without regard to the distribution of dividends.[32] Dividends reduce the owner's equity but they are *not* an expense.[33] If "profits" is given its general meaning there were sufficient profits in 1939

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[30] Natco Corporation v. United States of America (3 Cir. filed Dec. 19, 1956); Pierce Estates v. Commissioner of Internal Revenue, 195 F. 2d 475 (3 Cir. 1952).

[31] The German corporations acquiesced in the payment of dividend arrearages on the preferred stock for the years 1930 through 1939. Because of this acquiescence, it is assumed both parties contemplated payment of arrearages prior to payment of the current semi-annual dividend.

[32] This was conceded by taxpayer, see T-R p. 17.

[33] Emphasis in text. Finney and Miller's Principles of Accounting, Introductory (4th Ed.).

from which to repay the guarantor regardless of whether "profits" is construed as meaning profits for the current year or profits from the inception of the business operation. With the existence of profits in 1939 from which to make reimbursement, the conditional obligation to repay the guarantor would have become absolute in that year.

In order to avoid the inevitable conclusion which follows from attaching the general meaning and usage to "profits", the taxpayer takes the position the word "profits" as used in the agreement means "accumulated profits" or "undistributed profits",[34] or "cumulative deficit or surplus",[35] i.e., profits remaining after dividend distributions on the preferred stock.[36] Plaintiff urges to hold against plaintiff would, (1) destroy the expressed intent of the agreement to subordinate the guarantor to the preferred stockholders; (2) do violence to the intent of the parties to the agreement as shown by their acts; and (3), ignore the fact that the semi-annual current dividend had to be deducted from profits available for reimbursement.

The agreement reflects an intent to subordinate the guarantor to the preferred stockholders. This sub-ordination was accomplished by delaying the right of repayment in the guarantor until after the preferred stockholders received their current semi-annual dividend. There is no

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[34] Plaintiff's Brief, p. 23.

[35] Plaintiff's Exhibit 4.

[36] At the conclusion of the calendar year 1939, American Bemberg had completed its fourth consecutive year of showing a gain. While there had been years in which taxpayer incurred sizable losses, an examination of the profit and loss statements, together with adjustments from the inception of the American corporation in 1925 up to and including 1939 reveals that gains exceeded losses in an amount sufficient to reimburse the foreign guarantor. However, if there is deducted the dividend distributions on the cumulative preferred stock for the years 1930-1939 from the amount by which the gains exceeded the losses for the entire operation of taxpayer from its inception in 1925 until 1939, there remains no "profits" from which to make reimbursement. The immediately preceding method of computation of "profits" is that urged by taxpayer.

indication in the agreement the preferred stockholders were to maintain their superior position after receipt of the current semi-annual dividend.[37]

The acts of the parties do not indicate any unusual or special meaning was to be attached to the word "profits". In fact, the record indicates the converse was true. The meaning of the word, "profits", was not questioned until 1939. In that year, the guarantor made demand for repayment[38] which was resisted by taxpayer on the ground of non-availability of profits for that purpose. In addition, in 1939, taxpayer sought the assistance of counsel as to the meaning of the word "profits" as used in the agreement.[39] Disagreement between the parties and the seeking of advice of counsel as to the meaning of the word "profits" are not acts consonant with a particular meaning affixed to the word as advocated by taxpayer.

Finally, the plaintiff urges the condition relating to payment of the current semi-annual dividend must be read jointly with the provision providing for reimbursement out of profits. The taxpayer reasons since the current semi-annual dividend had to be paid before reimbursement could be made out of profits, the usage of "profits" in the agreement contemplated only profits remaining after dividend distributions.

The agreement of July 16, 1925 does not provide the source from which dividend payments on the prefefred stock should be made. However, the stock certificate[40] provides dividends were to be paid from "surplus" or

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[37] Whether the preferred stockholders would maintain a preference upon liquidation because of the last clause in paragraph third is not determined.

[38] The record, T-R pp. 26, 35, contains inadmissible hearsay evidence to the effect that such demand by the guarantor was due to pressure exerted by the German government.

[39] Defendant's Exhibit 1.

[40] Plaintiff's Exhibit "E".

"net profits" of the corporation. If "profits" as used in the agreement is defined as "net profits", it would be possible for the net profit figure to be the same after a dividend payment as before, since payment could be made out of surplus. On the other hand, if "profits" is defined as surplus, it would be possible for the surplus figure to be unchanged after a dividend distribution by reason of the dividend having been paid from net profits. Unless one assumes the untenable position that profits as used in the agreement means two things, viz. "net profits" and "surplus", or unless it is assumed "net profits and surplus" are synonymous, which assumption the court is unable to accept, the final argument of the plaintiff must fall because the reason in support of it cannot withstand close scrutiny.

The court for tax purposes is concerned with the year in which the duty to repay principal and interest was transformed from a contingent obligation to an absolute one as distinguished from the time for the physical transfer of funds from American Bemberg to the assignee of the guarantor. While there might be no funds from which to make reimbursement, because profits have been disbursed by dividend distributions, it does not mean there were not profits so as to make the obligation to make repayment absolute.

Being unable to find circumstances which indicate a departure was intended from the general meaning and usage of the word, "profits", it is concluded the ordinary meaning of language should be given the word. Restat. Contracts, § 235(a); Corbin on Contracts, § 542.

The interest deduction urged by plaintiff must be denied.

An order in accordance herewith may be submitted.

at Wilmington,
March 29, 1957

Present: GOODRICH, MCLAUGHLIN and HASTIE, Circuit Judges.

Judgment

This cause came on to be heard on the record from the United States District Court for the District of Delaware and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby affirmed.

Attest:
S/ IDA O. CRESKOFF
Clerk

March 14, 1958

Sur Petition for Rehearing

Present: GOODRICH, MCLAUGHLIN and HASTIE, Circuit Judges.

After due consideration, the petition for rehearing in the above-entitled case is hereby denied.

By the Court
S/ WILLIAM H. HASTIE
Circuit Judge

Dated:
April 22, 1958

SUPREME COURT, U. S.
Office Supreme Court
FILED
AUG 28
JAMES R. BROWN

No. 194

In the Supreme Court of the United States

October Term, 1958

AMERICAN BEMBERG CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR THE UNITED STATES IN OPPOSITION

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---

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (Pet. 5a-21a) is reported at 150 F. Supp. 355. The opinion of the Court of Appeals (Pet. 1a-5a) is reported at 253 F. 2d 691.

JURISDICTION

The judgment of the Court of Appeals was entered March 14, 1958. (Pet. 21a.) Rehearing was denied April 22, 1958. (Pet. 21a.) The petition for certiorari was filed July 21, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, in the particular circumstances of this case, the taxpayer's originally contingent obligation to pay interest on advances made to it by its corporate common stockholders became definite and unqualified in 1939.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to

clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 43.)

STATEMENT

American Bemberg Corporation, the taxpayer, is a Delaware corporation and on the accrual basis. Between 1925 and 1929, certain expenditures were made for its benefit by its principal voting stockholders, two German corporations, Vereinigte Glanzstoff Fabriken (referred to as Glanzstoff) and J. P. Bemberg, Actiengesellschaft (referred to as Bemberg). These German corporations, in order to make a cumulative preferred stock issue of the taxpayer attractive to the American public, guaranteed the punctual payment of semi-annual dividends on that stock from July 1, 1925, to July 1, 1929. The agreement, which was in writing, provided that the sums advanced under its terms would be repaid by the taxpayer with interest at the rate of five percent per annum. (Pet. 1a-2a.) However, the obligation to repay was qualified as follows (Pet. 2a):

> . . . and to that end, it is hereby agreed that Glanzstoff and or Bemberg shall be entitled to all accumulations of dividends upon such preferred stock which shall not have been paid by the American Corporation, and the amount of which Glanzstoff and or Bemberg have paid to the record holders of certificates for such preferred stock pursuant to said guaranty, and it is further agreed that whenever the American Corporation declares dividends on account of

any or all such accumulations of dividends, the same shall be paid to Glanzstoff and or Bemberg, provided however, that no dividends shall be declared and paid on account of any such accumulation of dividends, or reimbursement made to Glanzstoff and or Bemberg until and unless the regular dividend for the then current semi-annual period shall have been declared upon the outstanding preferred stock of the American Corporation, and a sum sufficient for the payment thereof set apart for that purpose; *nor shall any reimbursement be made to Glanzstoff and or Bemberg except out of the profits of the American Company;* . . . [Emphasis added.]

The German corporations advanced $796,250 to the taxpayer to enable it to meet its dividend obligations to preferred stockholders between 1925 and 1929. During the period 1925 to 1935, inclusive, except for the years 1928 and 1933, the taxpayer suffered annual losses. However, in each of the years from 1936 to 1940, inclusive, it earned a profit. Excluding the amount of dividends on preferred stock from 1930 to 1939, inclusive, profits as of 1939 were sufficient to enable the taxpayer to repay with interest the advances made by the German corporations.[1] (Pet. 3a.)

The taxpayer contended in both courts below that under its agreement with the German corporations its entire obligation for interest, since 1935, accrued in 1940, when, for the first time, its profits exceeded the

[1] The Court of Appeals stated that the dividends were unpaid, whereas, in fact, they were paid. (Pet. 12a, 17a.) The error is not significant for present purposes, since, in any event, the Court of Appeals was dealing with the relation of dividends, paid or unpaid, to profits.

dividends accumulated on the stock since 1930. The Commissioner, however, determined that "profits", as contemplated by the agreement, existed in 1939; that, accordingly, the prior contingent liability for interest became fixed in that year, and not in 1940. The Commissioner's determination was based on a construction of the taxpayer's contract with the two German corporations which would require the payment of interest when, in any one year, the current preferred dividend having been paid, there was an excess of income over expenses and losses—or "profits"—without reference to dividends.

The District Court agreed with the Commissioner's interpretation of the agreement (Pet. 6a-20a.), and the Court of Appeals unanimously affirmed (Pet. 1a-5a).

ARGUMENT

1. The decisions below, in holding that the petitioner could not deduct in 1940 certain originally contingent obligations for the payment of interest which had become fixed and definite prior thereto, correctly applied the well established principle that in the case of a taxpayer on the accrual basis an item of expenses is to be regarded as incurred, and hence deductible as accrued, only in the year in which the liability to pay becomes definite and absolute, whether or not presently paid or payable. *Dixie Pine Co.* v. *Commissioner*, 320 U. S. 516, 519; *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, 284; *United States* v. *Anderson*, 269 U. S. 422; *Natco Corp.* v. *United States*, 240 F. 2d 398, 400 (C. A. 3).

The taxpayer does not controvert the relevance of this principle, but contends in effect that it was applied by both courts below on an erroneous factual premise. Specifically, taxpayer contended below that the term "profits" as used in its agreement with the German corporations contemplated allowance not only for the ordinary losses of a given year but also for prior dividend obligations, on which hypothesis there would not have been, until 1940, any "profits" requiring reimbursement to the German corporations. But, as the Court of Appeals observed, this construction of the agreement was an "extraordinary" one, and "plainly inconsistent" with the terms of the agreement (Pet. 4a); and as the District Court concluded, the acts of the parties to the agreement did not "indicate [that] any unusual or special meaning was to be attached to the word 'profits'" but rather "the record indicates the converse was true" (Pet. 19a). The concurrent inferences of both courts below that the parties intended to use the word "profits" in its "general meaning and usage" without regard to dividends (Pet. 4a, 20a)—consonant only with an accrual for liability for interest in 1939, and not 1940—should, in accord with usual practice, be regarded as conclusive by this Court. *Comstock* v. *Group of Investors*, 335 U.S. 211, 214.

2. There is no conflict of decisions. In denying that its obligation to pay interest had accrued in 1939, the taxpayer, relying upon *Dixie Pine Co.* v. *Commissioner*, *supra*, asserted for the first time in the Court of Appeals that there was no accrual of liability in 1939 because it had resisted the claims of the German

corporations in that year. But as the decision below properly noted (Pet. 3a), the significance of the taxpayer's 1939 conduct would depend "upon the nature, the grounds and the extent and duration of its alleged resistance to the lenders' claims," and "A contention which requires such factual elaboration cannot be introduced into this case as a new matter on appeal."

Nor did such restriction constitute (Pet. 11) "a plain miscarriage of justice" within the meaning of *Hormel* v. *Helvering*, 312 U. S. 552, 558. The record does not show what form, if any, the "resistance" took in 1939, or any other fact which would have enabled the Court of Appeals to determine the extent of any contingency created thereby. In any event, even if a contingency had existed in 1939, for all the record shows it could well have continued into, and past, 1940, thereby precluding the interest deduction in the year in which taxpayer claimed it.

The taxpayer's additional contentions, (1) that the decision below erroneously defines the terms "profits" (Pet. 11-15), and (2) that it is in conflict with decisions of this Court regarding the construction of contracts (Pet. 15-16), are patently without merit. As to (1), none of the cases cited by taxpayer requires allowance for current or prior dividends in computing the profits available for distribution as dividends. Nor was there any such requirement under Delaware law. (Pet. 1a.) Delaware General Corporation Law, Sec. 35 (Delaware Revised Code (1915), Sec. 1949); 1 Delaware Code, Title 8, Sec. 170; 35 Delaware Laws, c. 85, Sec. 16; 36 Delaware Laws, c. 135, Sec. 16. See *Wittenberg* v. *Federal Mining & Smelting Co.*, 15 Del. Ch. 147, affirmed, 15 Del. Ch. 409; *Weinberg* v. *Baltimore Brick Co.*, 111 A. 2d 812 (S. Ct. Del.). As to (2), contrary to taxpayer's assertions, both the District Court and the Court of Appeals, for reasons already stated, correctly construed the contract. (Pet. 3a-4a; 18a-19a.)

CONCLUSION

The decision of the court below is correct, there are no conflicting decisions, the case turns on its particular facts, and further review is not warranted. It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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